No. 80-1599

MAY 6 1981

In the Supreme Court of the United States

OCTOBER TERM, 1980

HOME MUTUAL INSURANCE COMPANY, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTIONS PRESENTED

In determining a casualty insurance company's underwriting income for federal income tax purposes, Section 832(b)(5) of the Internal Revenue Code of 1954 allows a deduction for "losses incurred" during the year as computed under a formula. Under these provisions, the "losses paid" during the year are reduced by the "unpaid losses" estimated as of the end of the preceding year and increased by the "unpaid losses" estimated as of the end of the current taxable year. Petitioner is a mutual casualty company which first became taxable on its underwriting income determined (with certain adjustments) under these provisions for its taxable year 1963.

The questions presented are:

1. Whether, in computing its "losses incurred" deduction under the statutory formula for 1963 and subsequent years, petitioner is entitled to reduce its "opening" balance of unpaid losses by the difference between the originally estimated amount of pre-1963 claims settled during the taxable year and the amount actually paid on those claims.

2. If the answer to the first question is in the negative, whether petitioner is subject to a direct tax beyond the scope of Congress' power to impose an income tax under the Sixteenth Amendment.

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OPINIONS BELOW

The opinion of the United States Tax Court (Pet. App. A39-A59) is reported at 70 T.C. 944. The opinions of the court of appeals (Pet. App. A1-A37) are reported at 639 F. 2d 333.

JURISDICTION

The judgment of the court of appeals was originally entered on April 29, 1980 (Pet. App. A61-A62). By order dated July 22, 1980, this judgment was vacated and rehearing en banc was granted (Pet. App. A62-A63). The judgment of the court of appeals, on rehearing, was entered on December 23, 1980 (Pet. App. A63-A64). The petition for a writ of certiorari was filed on March 20, 1981. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTES AND REGULATIONS INVOLVED

The relevant portions of Section 821, 823 and 832 of the Internal Revenue Code of 1954 (26 U.S.C.) are set forth at Pet. App. A67-A74. The relevant portions of Section 1.832-4 of the Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.) are set forth in the Appendix, *infra*, 1a.

STATEMENT

Petitioner is a mutual casualty insurance company with its principal office in Appleton, Wisconsin. In each state in which petitioner is authorized to act as an insurer, petitioner is required to file an annual statement of its financial condition and the results of its operations for the year. These annual statements are presented on forms prescribed by the National Association of Insurance Commissioners (NAIC) and completed in accordance with instructions prepared by that organization. In its annual statement for 1962, petitioner reported "unpaid losses" as of December 31, 1962, of $2,729,746. This represented petitioner's estimate of the amount necessary to meet all existing claims against its insurance policies as of that date (Pet. App. A40-A44).

As of January 1, 1963, mutual casualty insurance companies, such as petitioner, were required to compute their income tax liability under the provisions of Sections 821-823 of the Internal Revenue Code of 1954 as amended by Section 8, Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 989. The Revenue Act of 1962 greatly increased the tax on mutual casualty insurance companies. Prior to that time, they had been taxed under one of two formulas, whichever produced the higher tax. Under one formula they were taxed at ordinary corporate rates on their investment income and were not taxed on their income from premiums (underwriting income). Under the other formula, they paid a tax of one percent on their gross investment income plus their premium income less policy holder dividends (Pet.

App. A2, A41; Sections 821 and 822, Internal Revenue Code of 1954 (26 U.S.C. 1958 ed.)). At the same time, stock casualty insurance companies were taxed at ordinary corporate income tax rates on their investment income and underwriting income (Pet. App. A41). The Revenue Act of 1962 sought to tax mutual casualty insurance companies on much the same basis as the stock casualty companies (Pet. A8, A41).

Under the 1962 Act, mutual casualty insurance companies are taxable on both their net investment income and their "statutory underwriting income." See Section 821(b) of the Code. The company's "statutory underwriting income" is determined (with certain adjustments and modifications) by reference to the pre-existing provisions of Sections 831 and 832 dealing with the taxation of nonmutual casualty insurance companies. Section 823(a)(1) of the Code. In general, "underwriting income" under these provisions consists of "premiums earned" during the year less expenses and "losses incurred." See Section 832(b)(3) and (c)(4). Specifically, Section 832(b)(5) provides that the "losses incurred" deduction is to be computed as follows:

> (A) To losses paid during the taxable year, add salvage and reinsurance recoverable outstanding at the end of the preceding taxable year and deduct salvage and reinsurance recoverable outstanding at the end of the taxable year.
>
> (b) To the result so obtained, add all unpaid losses outstanding at the end of the taxable year and deduct unpaid losses outstanding at the end of the preceding taxable year.

This formula for computing the "losses incurred" deduction was first enacted 60 years ago in Section 246(b)(6) of the Revenue Act of 1921, ch. 136, 42 Stat. 263, for use in computing the taxable income of stock casualty insurance companies and has been reenacted without substantial change.

In computing its "losses incurred" deduction for 1963 under this formula, petitioner added to losses paid during the year the amount of its estimated "unpaid losses" as of the end of that year, and subtracted the amount of its estimated "unpaid losses" as of December 31, 1962, as reported on its NAIC annual statement for that year. Because not all of the claims against petitioner existing as of December 31, 1962, were settled until 1975, it continued to include in year-end "unpaid losses" taken into account under this formula for each succeeding year until 1975, amounts estimated for such pre-1963 claims. The total amount ultimately paid with respect to these pre-1963 claims over this period, however, was less than the amount originally estimated. As a result, the aggregate amount of "losses incurred" deductions over this period was $402,314.59 less than the amount that would have been deductible had petitioner's original estimate of "unpaid losses" as of December 31, 1962, been equal to the amount ultimately paid on such pre-1963 claims (Pet. App. A43-A48).

In determining its "losses incurred" deduction for 1963-1966, however, petitioner excluded the subrogation recoveries on claims paid prior to January 1, 1963. On audit, the Commissioner of Internal Revenue determined that these subrogation recoveries were not excludible in computing the "losses incurred" deduction. As a result of this determination and certain other adjustments, the Commissioner determined deficiencies in petitioner's tax liability for 1966 and 1971 in the respective amounts of $29,906.21 and $18,624.50 (Pet. App. A3-A4, A39, A43).

In this proceeding for redetermination of the Commissioner's deficiencies brought by petitioner in the Tax Court, petitioner raised the issue of subrogation recoveries only as an alternative to its principal contention that the "opening" balance of its "unpaid losses" for each taxable year (*i.e.*, the amount subtracted from the sum of losses paid during the

year and "unpaid losses" as of the end of the taxable year under Section 832(b)(5)(B)) should have been reduced by the difference between the original estimate of pre-1963 claims settled during the year and the amount for which those claims were actually settled.[1] Petitioner's principal argument in the Tax Court in support of this claim was that, because its "unpaid losses" as of December 31, 1962, had not previously been taken into account in determining its income tax liability, the "tax benefit rule" permitted subsequent adjustments of the overestimated amounts in computing taxable income or loss for 1963 and subsequent years (Pet. App. A3-A4, A51-A52).

The Tax Court unanimously rejected petitioner's argument that the tax benefit rule itself permitted such adjustments. It observed that the overestimation of losses "had no bearing upon petitioner's gross income from its underwriting activities," but instead affected only the computation of its "losses incurred" deductions under Section 832(b)(5) (Pet. App. A51). Nevertheless, the Tax Court analogized the Section 832(b)(5) formula to the computation of the cost of goods sold where inventories are utilized. As a result, it held, with one judge dissenting (Pet. App. A56-A59), that petitioner was entitled under the statute to recompute its opening balance of its "unpaid losses" for each of the years in question to reflect the actual amount paid in that year for pre-1963 claims (Pet. App. A9-A10, A47-A49). Because it held for petitioner on this basis, the Tax Court found it unnecessary to reach petitioner's alternative contention

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[1]The computations for 1963, 1964 and 1965 are also involved in this proceeding to the extent that loss carryovers for those years may affect petitioner's liability for the two years (1966 and 1971) directly before the Tax Court (Stipulation of facts at 3).

that subrogation recoveries on pre-1963 claims should be excluded from the computations provided for under Section 832(b)(5)(A).[2]

In an en banc decision, the court of appeals reversed the Tax Court with respect to the adjustments in petitioner's unpaid losses. The court held that unless petitioner's original estimate of the unpaid losses was itself unreasonable, no recomputation of those unpaid losses could be retroactively made under the statutory formula to reflect the exact amounts that are subsequently expended on the claims. The court noted that the statutory scheme had been in effect for 60 years without material modification on this point and that there was no support in the legislative history for the retroactive adjustment sought by petitioner with respect to computing its losses incurred deduction. In reaching this result, the court of appeals agreed with the Tax Court that the "tax benefit rule" had no application and rejected petitioner's argument that the statute as interpreted resulted in the imposition of an unconstitutional direct tax (Pet. App. A1-A37). The court of appeals accordingly remanded the case to the Tax Court for consideration of petitioner's alternative arguments (Pet. App. A24).

ARGUMENT

1. The court of appeals correctly held that in computing the losses-incurred deduction under Section 832(b)(5) of the Code (Pet. App. A71), petitioner's unpaid losses for claims existing as of December 31, 1962, could not be adjusted in the years of settlement to reflect the amounts actually paid out with respect to those claims.

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[2]The Tax Court held against petitioner with respect to an issue involving the appropriate point at which the special transitional underwriting loss under Section 821(e) of the Code may be utilized to reduce statutory underwriting income (Pet. App. A52-A56). The court of appeals agreed with the Tax Court's determination on this point (Pet. App. A24-A28, A30, A37), and petitioner has not sought further review with respect to this issue.

Moreover, the question presented is of limited administrative importance. It arises only in the context of the proper treatment of pre-1963 unpaid losses of mutual casualty companies, and is therefore non-recurring once all such claims have been satisfied. As a result, there has been little litigation involving this issue, and we are aware of no other case currently pending in a court or at the administrative level presenting the question raised by the petition.

As petitioner (Pet. 3) and the court below (Pet. App. A7) recognized, there is nothing in this 60-year old statutory formula that would permit the adjustment sought by petitioner in computing its losses-incurred deduction. The computation of this deduction begins with losses paid during the tax year with adjustments for changes during the year in salvage and reinsurance recoverable. The resulting figure is then adjusted by adding the "unpaid losses outstanding at the end of the current taxable year" and subtracting the "unpaid losses outstanding at the end of the preceding taxable year." The term "unpaid losses" is a longstanding term of art within the insurance industry, referring to the company's estimate, as of the end of each year, of the amount of claims then in existence (whether or not reported and whether or not the actual amount of reported claims has yet been ascertained) remaining unsatisfied at that time. See Treasury Regulations, Section 1.832-4(a)(5) and (b) (App., *infra*, 1a). As long as the company's estimate of such "unpaid losses" is "reasonable," it is controlling for tax purposes. *Hanover Insurance Co.* v. *Commissioner*, 598 F. 2d 1211 (1st Cir.), cert. denied, 444 U.S. 915 (1979). There is no evidence that petitioner's estimate of unpaid claims as of December 31, 1962, was unreasonable. Accordingly, the statute requires that the estimated amount be used in computing petitioner's "losses incurred" deduction.

The use of conservatively estimated unpaid losses, like the use of conservatively calculated insurance reserves, will ordinarily operate to a company's advantage for tax purposes, by permitting it to claim greater current deductions against current premium income. On the other hand, an overestimate of "opening" unpaid losses may, in certain circumstances, work to the disadvantage of a company (such as a mutual casualty company) that changes from a non-taxable to a taxable status with respect to its underwriting income.[3] Nevertheless, as the court of appeals noted (Pet. App. A7), there is nothing in the legislative history of the Revenue Act of 1962 "revealing even a glimmer of any intent that [petitioner] would be allowed to make the retroactive adjustment it wishes." And petitioner has not contended otherwise. In the only prior cases involving closely analogous circumstances the courts have squarely rejected the contention that taxpayers could avoid the adverse consequences of similar overestimates of insurance reserves as of the end of the last year before they became taxable on their underwriting income. *Lutheran Mutual Life Insurance Co.* v. *United States*, 602 F. 2d 328 (Ct. Cl. 1979), cert. denied, 446 U.S. 936 (1980); *Pacific Mutual Life Insurance Co.* v. *Commissioner*, 48 T.C. 118, 120-131 (1967), rev'd on other issues, 413 F. 2d 55 (9th Cir. 1969).

Petitioner, however, claims (Pet. 9-20) that the adjustments are permitted under the so-called "tax benefit rule."

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[3]Whether such an overestimate of the "opening" unpaid losses for the first year of taxability will actually result in reduced "losses incurred" deductions for that and for subsequent years will depend, of course, on whether the company continues to estimate its "unpaid losses" on the same conservative basis. If it does so, the effect of the original overestimate of unpaid losses will be offset, each year, by the addition to the allowable losses incurred deduction of a similarly overestimated amount of unpaid losses as of the end of the current year. See discussion, page 11, note 7, *infra*.

But as a unanimous Tax Court (Pet. App. A51-A52) and the majority of the court of appeals (Pet. App. A15-A22, A30-A31) correctly recognized, that rule is inapplicable here. The "tax benefit rule" is not concerned with the allowance of additional deductions. Rather it deals with required inclusions in gross income where an item previously deducted was recovered by the taxpayer in a later period. Essentially, the "tax benefit rule" provides that recoveries of previously deducted items must be included in gross income, but only to the extent that the deduction resulted in a prior reduction of income tax.[4] Here, the Commissioner has not attempted to include any such recovery in petitioner's gross income on this basis.[5] Instead, a deduction for "losses incurred" allowed against income from premiums earned has been limited in accordance with the specific terms of the statute.

The authorities upon which petitioner relies (Pet. 12, 16, 17-18) demonstrate the inapplicability of the "tax benefit rule" to this case. In each of those instances, there was an inclusion in gross income of certain recoveries and, where necessary, a determination of how much of that recovery might be excluded from gross income because it had provided no previous tax benefit. There is, accordingly, no

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[4]See, *e.g.*, Section 111(a), Internal Revenue Code of 1954 (26 U.S.C.); Section 1.111-1(a), Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.); *Dobson* v. *Commissioner*, 320 U.S. 489 (1943); *Tennessee-Carolina Transportation, Inc.* v. *Commissioner*, 582 F. 2d 378 (6th Cir. 1978), aff'g 65 T.C. 440 (1975), cert. denied, 440 U.S. 909 (1979); Bittker and Kanner, *The Tax Benefit Rule*, 26 U.C.L.A. L. Rev. 265 (1978); O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 Tax L. Rev. 215 (1972), 1 J. Mertens, *Law of Federal Income Taxation* § 7.34 (rev. ed. 1974).

[5]The dissent does not appear to argue that petitioner's overestimation of its unpaid losses as of the end of 1962 had any bearing upon its gross income. Rather, it focuses upon the effect on petitioner's taxable income (Pet. App. A29, A35, A37).

basis for petitioner's contention (Pet. 13-17) that the exclusionary aspect of the tax benefit rule should apply here even though no recovery has been included in its gross income, or for its further argument that the decision of the court below rejecting the application of the tax benefit rule is contrary to the pertinent judicial and administrative authorities.[6]

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[6]Thus, for example, in *Dobson* v. *Commissioner*, 320 U.S. 489 (1943), which petitioner erroneously alleges (Pet. 17-18) to conflict with the decision below, the Commissioner sought to include in the taxpayer's gross income a recovery attributable to shares sold in a previous year at a loss, for which the taxpayer had claimed a deduction. The Court held that this recovery was not required to be taken into gross income where the deduction of the losses had resulted in no tax benefit.

The other decisions cited by petitioner (Pet. 12, 16) are likewise distinguishable. See *California and Hawaiian Sugar Refining Corp.* v. *United States*, 311 F. 2d 235 (Ct. Cl. 1962), holding that a recovery of taxes paid when taxpayer was exempt from tax was not required to be included in gross income; *Home Savings & Loan Co.* v. *Commissioner*, 39 T.C. 368 (1962), acq. in result only, 1963-2 Cum. Bull. 4, as supplemented by 1965-1 Cum. Bull. 4 and 1965-2 Cum. Bull. 5, holding that a return of a property tax refund was not includible in income where tax was paid in a year that taxpayer was exempt from income tax; *Birmingham Terminal Co.* v. *Commissioner*, 17 T.C. 1011 (1951), acq. 1952-1 Cum. Bull. 1, holding that an amount received for losses on retirement of railway facilities was not included in income where such losses had either not been deducted or had been deducted with no tax benefit; *M & E Corp.* v. *Commissioner*, 7 T.C. 1276 (1946), acq. 1947-1 Cum. Bull. 3, holding that the restoration to income of unused reserve for losses was not required to the extent that the deduction for the amounts previously added to the reserve resulted in no tax benefit; *Dallas Title & Guaranty Co.* v. *Commissioner*, 40 B.T.A. 1022, 1031 (1939), rev'd on other grounds, 119 F. 2d 211 (5th Cir. 1941), holding that that part of a legal reserve for which a deduction had been allowed in prior years was included in income in the year released to general use. See also Rev. Rul. 58-126, 1958-1 Cum. Bull. 13 (a transfer by a savings and loan association to its undivided profits account from its reserves of an amount previously added to the reserves when the taxpayer was not subject to tax did not result in the production of gross income); and, *American Financial Corp.* v. *Commissioner*, 72 T.C. 506 (1979), holding that the amount of subrogation recoveries taken into account in the computation of "losses incurred" was limited to those recoveries relating to claims that had previously been deducted.

Moreover, in *Tennessee-Carolina Transportation, Inc.* v. *Commissioner, supra*, 582 F. 2d at 378, the court held that a corporation

In this regard, both petitioner (see, *e.g.*, Pet. 10, 13 19) and the dissenting opinion below (Pet. App. A29, A37) confuse the concepts of gross income and taxable income. The "tax benefit rule" deals with the inclusion in gross income in a year of a recovery. That the overestimation of petitioner's unpaid loss may have had a bearing in the determination of the ultimately allowable "losses incurred" deductions, and, hence, in the determination of petitioner's taxable income in the years its pre-1963 claims were settled, does not provide a basis for overriding the statutory formula set forth in Section 832(b)(5).[7]

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involved in a Section 336 liquidation was required to take into gross income an amount equal to the value of the previously expensed but not fully consumed tires and tubes that were distributed to its shareholders. In *Commissioner* v. *Anders*, 414 F. 2d 1283 (10th Cir. 1969), and the other cases cited by petitioner (Pet. 19) involving Section 337, the courts required that recoveries of previously deducted expenses be included in gross income when property was sold in a Section 337 liquidation.

We agree with the court of appeals' conclusion (Pet. App. A20-A22 & n.38), that the rationale of the Tax Court's decision in *American Financial Corp.* (applying the "tax benefit rule" in the case of subrogation recoveries under Section 832(b)(5)(A)) is erroneous. In any event, the Tax Court there specifically reaffirmed the inapplicability of the "tax benefit rule" with respect to adjusting the "unpaid loss[es]" part of the "losses incurred" deduction (72 T.C. at 514 n.5).

[7]Petitioner's initial overestimate of "unpaid losses" may never have any real impact on its taxable income as long as its "unpaid losses" as of the end of each succeeding period are estimated on the same "conservative" basis. Thus, the claim that petitioner has been unfairly taxed during the years in question on amounts greater than its actual economic net income for those years is based on the dubious premise that its estimated "unpaid losses" for succeeding periods never exceeded its actual liability for the claims in question. If that is not the case, it is apparent that it has been treated as favorably as any other company that has consistently over-estimated its outstanding "unpaid losses." Indeed, prior to 1962 the mutual casualty insurance companies, such as petitioner, enjoyed the greater privilege, unrelated to the overestimates of "unpaid losses", of exemption from taxation on underwriting (premium) income or a much smaller tax on such income.

Indeed, it has never been thought that the tax benefit rule should displace the applicability of the specific statutory formula of Section 832(b)(5) for the computation of the "losses incurred" deduction, even though there are many instances in which, for one reason or another, a company may not have enjoyed the full benefit of a deduction for estimated "unpaid losses." For example, a company may have incurred a loss in the year in which the "unpaid losses" were estimated, and may be unable fully to utilize that loss in other taxable years. Although the statutory provisions have been in existence for more than half a century, it has never been suggested that the lack of a prior "tax benefit" would enable the company thereafter to adjust its original estimate of unpaid losses. Deductions are matters of legislative grace and depend on a showing that the claim falls within the terms of a specific statutory authorization. *Commissioner* v. *National Alfalfa Dehydrating and Milling Co.*, 417 U.S. 134, 149 (1974); *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440 (1934). Simply put, petitioner seeks to rewrite the statutory formula to cure what it believes to have been a congressional oversight or omission. But the courts are without power to recast a statute simply because they believe that it could be improved.[8]

2. The decision below correctly rejected petitioner's further argument (Pet. 20-25) that Section 832(b)(5), as applied by the court of appeals, results in the imposition of a direct tax, not on income, but on property, and is therefore unconstitutional because the tax is not apportioned among the states. The power to impose taxes was given to Congress by the Constitution subject to a prohibition against taxing

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[8]See, *e.g.*, *TVA* v. *Hill*, 437 U.S. 153, 194-195 (1978); *United States* v. *Calamaro*, 354 U.S. 351, 357 (1957); *Lewyt Corp.* v. *Commissioner*, 349 U.S. 237, 240 (1955); *United States* v. *Olympic Radio & Television, Inc.*, 349 U.S. 232, 236 (1955).

exports and the two conditions that "Duties, Imposts and Excises shall be uniform throughout the United States" and that no "capitation, or other direct, Tax" shall be laid unless apportioned among the several states in proportion to their respective numbers as disclosed by the census (United States Constitution, Article I, Section 2, clause 3; Section 8, clause 1, and Section 9, clauses 4 and 5). Subject to these restrictions, Congress' authority to tax "is exhaustive and embraces every conceivable power of taxation." *Brushaber* v. *Union Pacific R.R.*, 240 U.S. 1, 12 (1916).

For more than a century following the adoption of the Constitution, it was consistently held that only taxes on real estate were direct taxes (*Hylton* v. *United States*, 3 U.S. (3 Dall.) 171 (1796); *Springer* v. *United States*, 102 U.S. 586 (1880)). In *Pollock* v. *Farmers' Loan and Trust Co.*, 157 U.S. 429 (1895), on reargument, 158 U.S. 601 (1895), this Court ruled that taxes on income derived by an individual from real and personal property were also direct taxes, subject to the apportionment requirement. While the statute in question in *Pollock* also imposed a tax on other categories of income (including gains or profits from business, privileges or employments), the Court held the statute inoperative as to the tax on income from those items, not on the ground that it was a direct tax, but rather on the ground it did not believe that Congress intended the statute to subject them to tax if rents, interest, and dividends were not taxed. *Knowlton* v. *Moore*, 178 U.S. 41, 53, 82-83 (1900). Thereafter, in *Flint* v. *Stone Tracy Co.*, 220 U.S. 107 (1911), the Court sustained the Act of Aug. 5, 1909, ch. 6, 36 Stat. 11, which imposed an unapportioned tax measured by the income from all sources (including income from investments) of corporations, joint stock companies, associations and insurance companies. In distinguishing *Pollock*, the Court noted that while the 1909 Act imposed an excise, measured by income, on the privilege of doing business in

the corporation form, "the tax [in *Pollock*] was held unconstitutional because it was in effect a direct tax on the property solely because of its ownership" (200 U.S. at 162).

The impediment found in *Pollock* to the imposition of an unapportioned tax on income derived from property was eliminated by the adoption of the Sixteenth Amendment. But the tax in question here is not imposed on the income derived from property but from services. Since such a tax would be permitted without apportionment in any event under the rationale of *Flint* v. *Stone Tracy Co., supra,* the Commissioner's position with respect to the operation of Section 832(b)(5) is in no way dependent upon the adoption, or construction, of the Sixteenth Amendment. Indeed, more than a century ago, this Court held valid against a challenge that it was an unconstitutional direct tax, the imposition of a tax upon the gross receipts of premiums or assessments of insurance companies. *Pacific Insurance Co.* v. *Soule,* 74 U.S. (7 Wall.) 433 (1868). Moreover, this Court has consistently recognized Congress' power to tax gross receipts and gross income (*Spreckels Sugar Regining Co.* v. *McClain,* 192 U.S. 397 (1904); *United States* v. *Kahriger,* 345 U.S. 22 (1953)). In *New Colonial Ice Co.* v. *Helvering, supra,* 292 U.S. at 440, the Court stated that "[t]he power to tax income * * * is plain and extends to the gross income." Indeed, as the majority of the court recognized (Pet. App. A32-A33), gross income was one measure (see pages 2-3, *supra*), upon which mutual companies, like petitioner, were taxed prior to 1963. That tax was upheld in *Penn Mutual Indemnity Co.* v. *Commissioner,* 277 F. 2d 16 (3d Cir. 1960). Petitioner does not contend that a tax on gross receipts, as involved in *Penn Mutual,* is unconstitutional (Pet. 24 n.38).

The tax now imposed on mutual casualty companies, is not based on gross receipts. Instead, Congress has allowed various deductions from gross premium income, including a deduction for "losses incurred" as determined under

Section 832(b)(5). If a tax on gross receipts from premium income is not an unconstitutional direct tax, a tax on gross premium income reduced by "losses incurred" is not an unconsitutional direct tax. All that is involved here is how large a deduction for "losses incurred" should be allowed against premiums earned during the taxable year.

At all events, even on the assumption that a substantial constitutional question would otherwise be presented, the record here fails to support peitioner's claim that it has been subjected to tax on a greater amount than it believes to be constitutionally permissible. While it was stipulated that petitioner's deductions for aggregate losses incurred for 1963-1975 were approximately $400,000 less than they would have been had its original estimate of unpaid losses as of December 31, 1963, accurately reflected the amount it would ultimately be required to pay on those claims, there is no showing that petitioner did not in fact continue to estimate its unpaid losses throughout this period on the same conservative basis. (See page 8 note 3 & page 11 note 7, *supra*.) To the extent it did so, the effect of taking the original overestimate of pre-1963 unpaid losses into account under the Section 832(b)(5) formula would be offset, in each year, by the addition to the deductible amount of similarly overestimated unpaid losses as of the end of that year.[9]

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[9]The constitutional argument presented in the petition was not raised in the Tax Court or in the court of appeals prior to rehearing. Moreover, the only constitutional question identified by the dissenting judges below concerned what they viewed as a retroactivity problem, based on the argument that the effect of taking the original overestimates of pre-1963 unpaid losses into account without adjustment under the statutory formula (if not offset by continuing overestimates of unpaid losses) would be to increase taxable income for 1963 and later years by amounts that might be more appropriately treated as having been earned prior to 1963 when such companies were effectively exempt from tax on underwriting income (Pet. App. A35-A37). Petitioner, however, has not advanced this "retroactivity" question in its petition. Moreover, the dissenting judges in the court below agreed that such

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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"retroactivity" would not be unconstitutional per se. Cf. *United States* v. *Darusmont*, No. 80-243 (Jan. 12, 1981). Instead, they were concerned primarily with whether Congress actually intended that the statute operate in this matter. It is clear, however, that Congress did intend that the underwriting income of mutual companies was to be computed in essentially the same manner as the underwriting income of non-mutual companies. Presumably, it was also aware that the provisions of existing law providing that the company's estimate of unpaid losses would be taken into account in determining the annual losses incurred deduction could work to the disadvantage as well as to the advantage of the company involved. Cf. *Lutheran Mutual Life Insurance Co.* v. *United States, supra*, 602 F. 2d at 330-332, discussing the legislative intent regarding a similar question with respect to the computation of reserves under the Life Insurance Company Income Tax Act of 1959.

APPENDIX

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.832-4 *Gross income.*

(a)(1) * * *

* * * * *

(5) In computing "losses incurred" the determination of unpaid losses at the close of each year must represent actual unpaid losses as nearly as it is possible to ascertain them.

(b) Every insurance company to which this section applies must be prepared to establish to the satisfaction of the district director that the part of the deduction for "losses incurred" which represents unpaid losses at the close of the taxable year comprises only actual unpaid losses stated in amounts which, based upon the facts in each case and the company's experience with similar cases, can be said to represent a fair and reasonable estimate of the amount the company will be required to pay. Amounts included in, or added to, the estimates of such losses which, in the opinion of the district director are in excess of the actual liability determined as provided in the preceding sentence will be disallowed as a deduction. The district director may require any such insurance company to submit such detailed information with respect to its actual experience as is deemed necessary to establish the reasonableness of the deduction for "losses incurred."